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IN THE UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF ARIZONA

In re)	Chapter 7
)	
SOUTHWEST SUPERMARKETS, LLC,)	CASE NO. 2-01-14805-RJH
)	through 2-01-14812
)	
Debtor.)	(Jointly Administered)
_____)	
)	
DANIEL P. COLLINS, Trustee for the)	
Bankruptcy Estate of SOUTHWEST)	ADVERSARY NO. 03-00945
SUPERMARKETS, L.L.C.; SOUTHWEST)	
HOLDINGS, L.L.C.,)	
)	
Plaintiffs,)	
)	OPINION RE
v.)	KOHLBERG’S MOTION TO DISMISS
)	SECOND AMENDED COMPLAINT
KOHLBERG AND COMPANY, et al.,)	
)	
Defendants.)	
_____)	

Defendants’ motion to dismiss argues that statutes of limitations bar the Trustee’s claims for breaches of fiduciary duty and for avoidance of fraudulent transfers to themselves by the Debtor’s managers. The Court concludes that the protections of statutes of limitations are not available to self-dealing fiduciaries. The Court also concludes that the discovery rule applicable to actual fraudulent transfers prevents the running of limitations against the hypothetical creditor of § 544(a)(2),¹ who is statutorily defined to lack knowledge of any wrongdoing. For these and other reasons, the motion to dismiss must be denied.

¹ Unless otherwise indicated, all chapter and section references are to the United States Bankruptcy Code, 11 U.S.C. §§ 101-1330.

1 **Background Facts**

2 The Trustee’s Second Amended Complaint (the “Complaint”) portrays a milking²
3 of the Debtor by its owners and managers from the time they took control of it until it filed
4 bankruptcy. Because this is a motion to dismiss, these well-pleaded allegations of the
5 Complaint must be treated as true.

6 On July 24, 1995, Kohlberg & Co. (“Kohlberg”)³ purchased Southwest
7 Supermarkets (“Southwest” or the “Debtor”), which became its wholly owned subsidiary.
8 Southwest then owned and operated approximately 23 retail grocery stores in and around
9 Phoenix and Tucson, Arizona, and El Paso Texas. The purchase price was approximately \$21.5
10 million. The Complaint alleges that Southwest was insolvent at the time of its acquisition, and
11 that its assets were used to finance approximately half of the purchase price, rendering it even
12 more insolvent.

13 As part of the acquisition, Kohlberg and Southwest entered into a “fee
14 agreement” where Southwest agreed to pay Kohlberg a \$1 million fee for its efforts in arranging
15 the acquisition. Southwest also agreed to pay Kohlberg a management fee each year of either
16 \$200,000 or five percent of earnings before interest, taxes, depreciation and amortization
17 (“EBITDA”), whichever was greater, for Kohlberg’s management services. Such fees were paid
18 based on positive EBITDA even though massive debt service, which is disregarded in the
19 calculation of EBITDA, caused Southwest to operate at a loss most years. As Southwest was
20 expanded to include 42 stores, its debt was increased from \$9.75 million to \$45.7 million, and
21 its annual interest expense increased from \$0.6 million to \$7.3 million. Yet while Southwest
22 lost more than \$20 million in 1997, Kohlberg was paid a management fee of \$200,000 based on

24 ² “Share-holders have been held liable for a corporation’s debt because they have milked a
25 corporation by payment of excessive dividends, by the sale of products to the shareholders at a reduced
26 price, or by exacting unreasonable management charges.” *Hambleton Bros. Lumber Co. v. Balkin Ent.,*
Inc., 397 F.3d 1217, 1230 (9th Cir. 2005), quoting *Amfac Foods, Inc. v. Int’l Systems & Controls Corp.*,
294 Ore 94, 654 P.2d 1092, 1102 n.11 (1982).

27 ³ The “Kohlberg Defendants” include Kohlberg & Company, L.L.C., KSSI G.P., Inc., KSSI
28 G.P. II, Inc., KSSI Management, L.P., KSSI Acquisition Company, L.P., and KSSI Acquisition
Company II, L.P.

1 positive EBITDA, and a \$450,000 management fee in 1998 when Southwest lost more than \$3.6
2 million. And because Southwest had its own President and CEO, there is no indication that
3 Kohlberg actually provided any services for these “management fees.”

4 Shortly after the acquisition in 1995, Kohlberg hired Jim Pack to serve as CEO
5 and President of Southwest. Pack purchased a 2% interest in Southwest for \$200,000. When
6 Pack resigned as CEO in May of 1997, Southwest purchased his 2% interest for \$1.5 million
7 and his vested options for \$1.869 million. Also in 1997, Jerome Miller, another Southwest
8 officer, was paid \$800,000 by Southwest for his vested options.

9 Southwest apparently also agreed to cover certain of the Kohlberg Defendants’
10 tax liabilities arising from their ownership of Southwest. In 1996 and 1997, Kohlberg estimated
11 that distributions of \$5,829,664 were necessary to pay the tax liabilities arising from
12 Southwest’s expected profits, and Southwest paid this amount to Kohlberg. The tax liabilities
13 that actually accrued for those years turned out to be approximately half of the amount that had
14 been disbursed to Kohlberg, but Southwest never requested a reimbursement of the overpayment
15 of approximately \$2.9 million, and none was ever made. An email from the Debtor’s CEO to
16 Kohlberg just one month prior to Southwest’s bankruptcy states that “All is quiet (at least within
17 my privy) regarding the \$2.9 million Company receivable from Kohlberg.”

18 Southwest filed this Chapter 11 case in November, 2001. While Southwest was
19 still debtor in possession, this Court approved a global settlement agreement among the Debtors,
20 the secured creditors and the Official Unsecured Creditors’ Committee. That agreement
21 assigned to the secured creditors all of the “Kohlberg claims” of the Debtor and Debtor in
22 Possession, which included all of the claims now being asserted by the Trustee.⁴ Very shortly
23 thereafter, the Court granted the Debtors’ motion for appointment of a Chapter 11 Trustee, and
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26 ⁴ The settlement agreement defined the “Kohlberg claims” that were assigned to the secured
27 creditors as “any and all causes of action that may exist against Kohlberg & Company or any of its
28 subsidiaries or affiliates for payments and/or distributions made by the Debtors prior to the Petition
Date.” This definition would include both debtor causes of action and trustee causes of action, *e.g.*,
avoidance actions.

1 Daniel Collins was subsequently appointed Trustee on May 30, 2002. On or about September,
2 2003, the secured creditors re-assigned to the Trustee all the claims that had been assigned to
3 them under the global settlement agreement. That re-assignment provides that any proceeds
4 generated from the litigation of the Kohlberg claims be distributed to creditors according to the
5 Code's priority scheme.

6 The Trustee filed the complaint initiating this adversary proceeding on November
7 4, 2003, just prior to expiration of the Code's two-year statutes of limitations,⁵ and subsequently
8 filed his First Amended Complaint. Kohlberg moved to dismiss it, largely on statutes of
9 limitations grounds. The Court granted Kohlberg's motion with respect to many counts of the
10 complaint, but granted the Trustee leave to amend to plead any reasons why the statutes of
11 limitations should be tolled.⁶ The Trustee filed the Second Amended Complaint (the
12 "Complaint"), and Kohlberg has again moved for its dismissal, again largely on grounds of
13 statutes of limitations. After supplemental briefing at the request of the Court and oral
14 argument, the Court took the motion under advisement.

15 **Self Dealing Fiduciaries Toll Statutes of Limitations**

16 The Second Amended Complaint asserts causes of action for both breach of
17 fiduciary duty and actual fraudulent transfers on account of: (1) the \$2.9 million tax
18 overpayments in 1996; (2) the \$2.3 million paid in May 1997 to buy out the interests of the
19 Debtor's CEO James Pack; and (3) payment of \$3.6 million from 1995 to 1999 as "acquisition
20 fees" and "management fees." Kohlberg has moved to dismiss all of these counts on grounds of
21 statute of limitations, and argues that no discovery rule should bar the running of the statute
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23 ⁵ Bankruptcy Code § 108(a) provides that if a statute of limitations on a debtor cause of action
24 has not expired as of the filing of the bankruptcy case, the trustee may assert such a cause of action
25 within the later of its ordinary limitations or two years after the filing of the bankruptcy case. Because
26 this case was filed on November 11, 2001, that extended time would have expired on November 11,
2003. The statute of limitations on trustee causes of action is also two years after the filing of the case,
pursuant to Code § 546(a)(1).

27 ⁶ *Collins v. Kohlberg and Company (In re Southwest Supermarkets L.L.C.)*, 315 B.R. 565
28 (Bankr. D. Az. 2004), hereafter "*Collins I.*"

1 because the Debtor’s secured creditors (who assigned these claims to the Trustee) had an
2 opportunity to discover the Debtor’s true financial condition.

3 The Trustee responds that statutes of limitations should be equitably tolled for
4 actions alleging fraudulent self-dealing by a fiduciary.

5 The Trustee’s position is well founded and well taken. Particularly Delaware law has
6 held for more than sixty years that equitable tolling is appropriate for actions alleging self-
7 dealing by corporate fiduciaries that results in insolvency:

8 Sound public policy requires the acts of corporate officers and
9 directors in dealing with the corporation to be viewed with a
10 reasonable strictness. . . . [W]here they are required to answer for
11 wrongful acts of commission by which they have enriched
12 themselves to the injury of the corporation, a court of conscience
13 will not regard such acts as mere torts, but as serious breaches of
14 trust, and will point the moral and make clear the principle that
15 corporate officers and directors, while not in strictness trustees,
16 will, in such case, be treated as though they were in fact trustees
17 of an express and subsisting trust, and without the protection of
18 the statute of limitations, especially where insolvency of the
19 corporation is the result of their wrongdoing.⁷

20 Subsequent cases made clear that although actual knowledge of the wrongdoing would render
21 this tolling doctrine inapplicable,⁸ the doctrine is distinct from and does not require a showing of
22 fraudulent concealment.⁹ This history and doctrine was recently explained and followed by the
23 First Circuit¹⁰ and by an Oklahoma Bankruptcy Court, the latter of which concluded: “Thus,
24 where a complaint satisfies the elements of a *prima facie* case for equitable tolling – *i.e.*, it
25 contains allegations of self dealing for profit by a fiduciary – it is ordinarily inappropriate to
26 summarily dismiss a claim as untimely under an otherwise applicable statute of limitations
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⁷ *Bovay v. H.M. Byllesby & Co.*, 27 Del. Ch. 381, 38 A.2d 808, 813 (Del. 1944).

⁸ *Bokat v. Getty Oil Co.*, 262 A.2d 246 (1970).

⁹ *Kahn v. Seabord Corp.*, 625 A.2d 269 (Del. Ch. 1993).

¹⁰ *Niehoff v. Maynard*, 299 F.3d 41, 50 (1st Cir. 2002) (applying Delaware law).

1 pursuant to Rule 12(b)(6) of the Federal Rules of Civil Procedure.”¹¹

2 Here the Defendants unquestionably had such fiduciary duties, and the complaint
3 unquestionably alleges their self dealing for profit. Kohlberg was being paid fees to provide
4 management for the Debtor. Due to the allegation of insolvency,¹² Southwest’s managers owed
5 fiduciary duties to Southwest’s creditors.¹³

6 The complaint also adequately alleges self dealing for profit. Kohlberg required
7 Southwest to pay to Kohlberg a \$1 million acquisition fee that provided no apparent benefit to
8 Southwest, but only to Kohlberg. Kohlberg required Southwest to pay it management fees
9 based on an earnings formula that disregarded the massive debt obligations that Southwest
10 incurred to generate such earnings, and that ultimately drove Southwest into bankruptcy.
11 Kohlberg required Southwest to pay exorbitant sums upon the retirement of its CEO, far in
12 excess of the value his stockholdings in an insolvent corporation could possibly have had. And
13 this self dealing for profit continued right up until the filing of the bankruptcy, because despite

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15 ¹¹ *In re Sheffield Steel Corp.*, 320 B.R. 405, 419 (Bankr. N.D. Okla. 2004).

16 ¹² The Complaint alleges that even with \$30 million booked as “goodwill” on Southwest’s 1996
17 financial statement, it yielded a net worth of only \$15 million. Complaint ¶ 40. That goodwill is
18 undoubtedly due to a GAAP convention for recording the excess purchase price paid over the value of
19 the assets. Because the Uniform Fraudulent Transfer Act defines solvency based on a “fair valuation”
of the assets, A.R.S. § 44-1002(A), such GAAP conventions are not utilized and goodwill that is not
realizable by creditors is disregarded. *Bay Plastics, Inc. v. BT Commercial Corp. (In re Bay Plastics, Inc.)*, 187 B.R. 315, 330-31 (Bankr. C.D. Cal. 1995).

20 ¹³ “When a corporation becomes insolvent, its directors and officers become fiduciaries of the
21 corporate assets for the benefit of creditors.” *A.R. Teeters & Assocs., Inc. V. Eastman Kodak Company*,
22 172 Ariz. 324, 333, 836 P.2d 1034, 1043 (App. 1992). Although “the equitable trust fund doctrine has
23 been the subject of considerable dispute,” “it remains valid law in Arizona.” *Id.* at 331, 836 P.2d at
24 1041. Because the doctrine “was judicially created to ensure that all creditors’ claims are first equitably
25 satisfied before stockholders may claim their rights upon the assets of an insolvent corporation,” *id.*, its
26 focus is protection of creditors rather than internal corporate governance. *See also Decker v. Mitchell*
27 *(In re JTS Corp.)*, 305 B.R. 529, 535-41 (Bankr. N.D. Cal. 2003)(discussion the evolution of the trust
28 fund doctrine under Delaware law). Therefore the choice of law should be governed by the debtor’s
principal place of business, where the creditors are located, or where the liquidation occurs, rather than
by the state of incorporation. Although neither the parties nor the Court has found an Arizona case
addressing equitable tolling in the context of self-dealing by fiduciaries, the Court believes that Arizona
would adopt the Delaware law, both because of its continued adherence to the corporate trust fund
doctrine and because Arizona has recognized similar grounds for tolling statutes of limitations in actions
against fiduciaries. *See Waugh v. Lennard*, 69 Ariz. 214, 211 P.2d 806 (1949).

1 Southwest's financial distress Kohlberg did not voluntarily repay the \$2.9 million tax
2 overpayment, nor require Southwest to demand it, but rather sought to keep "quiet" about it.
3 Equitable tolling is appropriate "when a fiduciary of two corporations causes one corporation to
4 pay money to the other for largely nonexistent services."¹⁴

5 The Court previously ruled that the Trustee cannot assert the Debtor's fiduciary
6 duty claims against Kohlberg because Delaware law holds that the managers of a wholly owned
7 subsidiary owe their fiduciary duties to the parent, not to the subsidiary.¹⁵ But the Court also
8 concluded that the Trustee can assert claims that were assigned to him by the secured creditors,
9 notwithstanding *Williams*,¹⁶ because the claims were assigned for the benefit of the estate with
10 no special strings attached for the benefit of the assigning creditors.¹⁷ That assignment consisted
11 not only of the debtor and creditor claims the Trustee previously held and had assigned to the
12 secured creditors, but also the claims that the secured creditors had previously held in their own
13 right. Such claims may include breach of fiduciary duty claims. In addition to those creditor
14 fiduciary duty claims, Bankruptcy Code §§ 544(a) and (b) vest in the Trustee the creditors'
15 fraudulent transfer claims.

16 Because the Complaint adequately alleges self dealing for profit by fiduciaries,
17 equitable tolling should apply to bar the statute of limitations defenses asserted by those
18 fiduciaries. The motion to dismiss Counts 1, 4, 5, 6, 8, 12 and 13 must therefore be denied.

19 **Code § 544(a) Gives Trustees Rights of Hypothetical Unknowning, Unsecured Creditors**

20 Alternatively, the Bankruptcy Code itself may effectively toll the statute of
21 limitations on these facts.

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23 ¹⁴ *End of the Road Trust v. Terex Corp. (In re Fruehauf Trailer Corp.)*, 250 B.R. 168, 193 (D.
24 Del. 2000), citing *Carlton Investments v. TLC Beatrice Int'l Holdings, Inc.*, 1995 Del. Ch. LEXIS 140,
1995 WL 694397 (Del. Ch. 1995).

25 ¹⁵ *Collins I*, 315 B.R. at 575-76.

26 ¹⁶ *Williams v. California 1st Bank*, 859 F.2d 664 (9th Cir. 1988).

27 ¹⁷ *Collins I*, 315 B.R. at 569-71.
28

1 In addition to the rights of actual creditors that are vested in trustees by Code §
2 544(b), Code § 544(a) also gives trustees the rights of certain hypothetical creditors. In
3 particular, Code § 544(a)(2) gives the trustee the rights of a creditor who extends credit on the
4 date of the petition and who obtains an execution that is returned unsatisfied.

5 While it is usually thought that § 544(a) merely provides the trustee an avoiding
6 power, particularly the power to avoid unrecorded or secret liens, there is good authority that it
7 was also intended to provide trustees with some affirmative rights of recovery. The
8 predecessor to § 544(a)(2) was added to the Bankruptcy Act in 1910,¹⁸ deleted in 1950,¹⁹ and
9 then restored in 1966.²⁰ The draftsman of that restoration explained that it was intended to
10 permit a trustee to obtain equitable relief, such as an injunction, receivership or levy on an
11 equitable asset, where state law would require an exhaustion of legal remedies as a condition of
12 such equitable relief.²¹ Despite the merger of law and equity, that requirement is apparently
13 still alive, at least in federal courts.²² Thus § 544(a)(2) was intended to permit the trustee to
14 “bring a ‘creditors’ bill’ to reach choses in action belonging to his debtor.”²³ A receiver

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16 ¹⁸ 4B COLLIER ON BANKRUPTCY ¶ 70.47[1], at 564 (14th Ed. 1978)(hereafter “*Colliers*”).

17 ¹⁹ *Colliers* ¶ 70.47[3], at 569.

18 ²⁰ *Colliers* ¶ 70.47[5], at 577.

19 ²¹Frank R. Kennedy, *The Bankruptcy Amendments of 1966*, 1 GA. L.REV. 149, 169 (Winter
20 1967); *Accord*, *Colliers* ¶ 70.64, at 730-31; Vern Countryman, *The Use of State Law in Bankruptcy*
21 *Cases (Part II)*, 47 N.Y.U. L. REV. 631, 650 (1972). *See Freedman’s Sav. & Trust Co. v. Earle*, 110
U.S. 710 (1884).

22 ²² *Gruppo Mexicano de Desarrollo, S.A. v. Alliance Bond Fund, Inc.*, 527 U.S. 308, 319
23 (1999)(“It was well established, however, that, as a general rule, a creditor’s bill could be brought only
24 by a creditor who had already obtained a judgment establishing the debt.”). Curiously, while holding
25 that federal equity jurisdiction could not permit injunctive relief prior to judgment because such relief
26 was not available to English courts in 1789, the Court rejected an argument that the district court could
27 have exercised such powers under state law in a diversity case. *Id.* at n.3. The Court declined to hear
that argument because it had not been raised below. But the plaintiff was not obligated to raise it below
because the plaintiff prevailed. The proscription against hearing arguments not raised below applies to
the losing party, the appellant. The “respondent is entitled, however, to defend the judgment on any
ground supported by the record.” *Bennett v. Spear*, 520 U.S. 154, 166 (1997).

28 ²³ *In re Western World Funding, Inc.*, 52 B.R. 743, 773 (Bankr. D. Nev. 1985).

1 appointed on such a creditors' bill may assert damage actions against those who harmed the
2 corporation.²⁴ A creditors' bill is an appropriate remedy for shareholder "milking" of a
3 corporation.²⁵

4 Kohlberg is correct that the Trustee's standing under § 544(a)(2) to bring a
5 creditors' bill only permits the Trustee to assert causes of action that the debtor corporation
6 could have asserted.²⁶ That does nothing for this Trustee because, as noted above and as held
7 in *Collins I*, this debtor corporation cannot assert breaches of fiduciary duty against its
8 managers, who owed their duties solely to the parent, Kohlberg. But the intent behind §
9 544(a)(2) to make a creditors' bill available to trustees is nevertheless very significant because
10 it demonstrates that some kinds of affirmative damages actions can be asserted under §
11 544(a)(2), not just avoidance of secret liens.

12 Probably most kinds of affirmative relief that a trustee might seek would not be
13 available under § 544(a)(2), because a creditor who extends credit on the date of petition will
14 always have become a creditor *after* the wrong complained of. Consequently the kinds of
15 actions that trustees might be able to bring under § 544(a)(2) will always be limited to those for
16 which remedies are available to subsequent creditors, and these may be rare. One of them that
17 does appear to be available, however, is an action for an actual fraudulent transfer. Under the
18 Uniform Fraudulent Transfer Act, a transfer made with actual intent to hinder, delay or defraud
19 creditors is fraudulent as to both present and future creditors,²⁷ as compared to constructive
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22 ²⁴ *E.g., Scholes v. Lehmann*, 56 F.3d 750, 754 (7th Cir. 1995).

23 ²⁵ *Hambleton Bros. Lumber Co. v. Balkin Ent., Inc.*, 397 F.3d 1217, 1232 n.16 (9th Cir. 2005),
24 quoting *Amfac Foods, Inc. v. Int'l Systems & Controls Corp.*, 294 Ore 94, 654 P.2d 1092, 1102 n.16
25 (1982).

26 ²⁶ "[T]he general proposition is apparent that the creditor is entitled to realize on whatever
27 property the debtor may himself be able to realize on." GARRARD GLENN, *THE RIGHTS AND REMEDIES*
28 *OF CREDITORS RESPECTING THEIR DEBTOR'S PROPERTY*, § 25, at 23 (1915).

²⁷ A.R.S. § 44-1004(A); Uniform Fraudulent Transfer Act § 4(a).

1 fraudulent transfers that are deemed fraudulent only as to existing creditors.²⁸ Another that
2 might be available is creditors' breach of fiduciary duty claims when insolvency has shifted the
3 managers' fiduciary duties from shareholders to creditors. Such claims may also be available
4 to those who became creditors after the point of insolvency, and hence to the creditors who
5 extended credit on the date of the petition. Here, this means that the Trustee can assert
6 creditors' breach of fiduciary duty claims, even though no such claims are assertable on behalf
7 of the Debtor.

8 The availability of affirmative relief under Code § 544(a)(2) may have broader
9 significance. For example, it may explain why § 544(a) vests the trustee with "rights and
10 powers" of such creditors expressly *in addition to* their avoidance actions, whereas § 544(b)
11 only vests avoidance rights. It may provide a precise statutory basis for the conclusions of
12 some courts that trustees can bring those kinds of affirmative actions, such as piercing the
13 corporate veil, that are generally available to all creditors and not personal to particular
14 creditors, even if under applicable state law the debtor corporation could not pierce its own
15 veil.²⁹ It may resolve trustees' *in pari delicto* problem,³⁰ at least where state law would free a
16 receiver from that defense.³¹

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18 ²⁸A.R.S. § 44-1005; Uniform Fraudulent Transfer Act § 5.

19 ²⁹*E.g.*, *St. Paul Fire and Marine Ins. Co. v. PepsiCo Inc.*, 884 F.2d 688, 700-01 (2d Cir. 1989);
20 *Koch Refining v. Farmers Union Central Exchange, Inc.*, 831 F.2d 1339, 1348-49 (7th Cir. 1987); *C.B.S.*
Inc. v. Folks (In re Folks), 211 B.R. 378 (9th Cir. BAP 1997); *Western World Funding, Inc.*, 52 B.R.
743, 773 n.9 (Bankr. D. Nev. 1995).

21 ³⁰*See* Tanvir Alam, "Fraudulent Advisors Exploit Confusion in the Bankruptcy Code: How *In*
22 *Pari Delicto* Has Been Perverted to Prevent Recovery for Innocent Creditors," 77 AM. BANKR. L.J. 305
23 (Issue 3, 2003). The "problem" arises because such claims vest in the trustee pursuant to Code § 541,
24 which has been interpreted as defining the trustee's rights by the facts as they existed "as of the
25 commencement of the case." *E.g.*, *Official Comm. Of Unsecured Creditors of Color Tile, Inc. v.*
Coopers & Lybrand, 322 F.3d 147 (2d Cir. 2003); *Official Comm. Of Unsecured Creditors v. R. F.*
Lafferty & Co., 267 F.3d 340 (3d Cir. 2001).

26 ³¹*Scholes v. Lehmann*, 56 F.3d 750, 754 (7th Cir. 1995)("[T]he defense of *in pari delicto* loses
27 its sting when the person who is *in pari delicto* is eliminated" and replaced by a receiver)(applying
28 Illinois law); *F.D.I.C. v. O'Melveny & Myers*, 61 F.3d 17, 19 (9th Cir. 1995)("[D]efenses based on a
party's unclean hands or inequitable conduct do not generally apply against that party's
receiver.")(applying California law).

1 But the Trustee's standing under § 544(a) has another significance here. Actions
2 brought by trustees under § 544(a), unlike those assertable under § 544(b), are assertable
3 "without regard to any knowledge of the trustee or any creditor." Consequently, if the
4 limitations on such an action is subject to a discovery rule, such as the discovery rule for actual
5 fraudulent transfers,³² the action is assertable on behalf of the hypothetical creditor who is
6 hypothesized to have had no knowledge of the wrongdoing. Thus even if the secured creditors
7 should have known of the Debtor's true financial condition and the Kohlberg defendants' self-
8 dealing, the hypothetical § 544(a)(2) creditor is not burdened with such knowledge.

9 In effect this may mean that there is no statute of limitations for those few kinds
10 of actions that may be maintained by a subsequent, innocent creditor. This may seem surprising
11 at first blush, but on further reflection it is not all that unusual. As noted above, for sixty years
12 Delaware has effectively eliminated any statute of limitations for actions against self-dealing
13 fiduciaries. And there has never been a statute of limitations for some other remedies, such as
14 piercing the corporate veil, equitable subordination, the "Deep Rock" doctrine,³³ and
15 substantive consolidation. Such liabilities that are not subject to statutes of limitation should
16 have already put corporate fiduciaries on notice that no running of time will absolve them of
17 their misuse of the corporate form to the detriment of innocent creditors.

18 The lack of knowledge of the hypothetical creditor of § 544(a)(2), coupled with
19 the discovery rule applicable to breaches of fiduciary duty and actual fraudulent transfers, also
20 means that Kohlberg's motion to dismiss these counts on statute of limitations grounds must be
21 denied.

22 **The Tax Advance Overpayment Claim Survives**

23 In 1996, Southwest Supermarkets paid Kohlberg \$2.9 million more than was
24 required by the operating agreements to cover Kohlberg's tax liability as a result of owning

25 ³² A.R.S. § 44-1009; Uniform Fraudulent Transfer Act § 9.

26 ³³ The "abuses in management" and undercapitalization that supported subordination of
27 Standard's claim extended back 15 years before Deep Rock's § 77B case was filed. *Taylor v. Standard*
28 *Gas & Electric Co.*, 306 U.S. 307, 310-11 (1939).

1 Southwest Supermarkets. Count 2 of the Second Amended Complaint seeks to recover this
2 amount on a theory of unjust enrichment. Kohlberg has moved to dismiss Count 2 on two
3 grounds: (1) because the claim is time barred by a three year statute of limitations under either
4 Delaware or Arizona law; and (2) because no liability for unjust enrichment can exist when the
5 parties' relationship is governed by a specific contract.

6 On the statute of limitations issue, the Trustee does not dispute that the action
7 was governed by a three year statute, but argues that the liability did not arise until the filing of
8 bankruptcy. The Trustee relies on an October 18, 2001 memorandum from the Debtor's CEO
9 to Kohlberg, which described the tax overpayment as "the \$2.9 million Company receivable
10 from Kohlberg." Kohlberg has not denied the existence of that memo nor argued that Kohlberg
11 responded by denying that it was a receivable. While this is a motion to dismiss rather than a
12 motion for summary judgment, so those facts are not necessarily established, they do
13 demonstrate the likelihood that the Debtor will be able to prove that both the Debtor and
14 Kohlberg regarded the tax overpayment to be a receivable as of the time of the filing of the
15 bankruptcy.

16 The Trustee also argues that because there was no express contractual provision
17 governing refund of such an overpayment, the understanding was that it would be used to
18 reduce subsequent obligations of Southwest Supermarkets to cover such Kohlberg tax
19 liabilities. The Trustee argues that the unjust enrichment claim therefore arose only upon the
20 filing of bankruptcy, which effectively determined that there would be no such future tax
21 obligations.

22 On this motion to dismiss, it appears the Trustee could prove facts supporting a
23 legal conclusion that an obligation to repay the overpayment only accrued upon the filing of the
24 bankruptcy case. The motion to dismiss based on statute of limitations grounds must therefore
25 be denied.

26 Kohlberg also argues that an unjust enrichment claim is barred because of the
27 existence of a contract that governs the relationship of the parties, citing two Arizona cases and
28 a Delaware case. None of those cases, however, concerns a situation where a party overpaid

1 what a contract required. In *Ashton*,³⁴ a construction contract called for the contractor to be paid
2 40 cents per ton of the amount of borrow the contractor was required to supply to the job site.
3 The contractor bid the judgment based upon the State's estimate of the tonnage of borrow that
4 would be necessary. In fact, however, the tonnage ultimately required was less than had been
5 estimated, because the borrow used was less dense than the State had estimated it. The
6 contractor sued to be paid the amount that had been estimated, asserting various legal theories.

7 The court rejected the contractor's unjust enrichment claim "summarily" because
8 the doctrine has no application where there is an explicit contract that has been performed.³⁵
9 That conclusion has no bearing, however, where a party has paid more than required by a
10 contract. In *Ashton*, for example, the contractor did not perform more work than was called for
11 by the contract. To the contrary, the contractor actually moved less tonnage than the parties had
12 estimated, but wanted to be paid on the basis of the erroneous estimate rather than on the basis
13 of what the contractor actually supplied.

14 Similarly, *Brooks*³⁶ was a suit by a borrower seeking to collect interest on the
15 amounts the borrower was required to pay the lender for real property tax and insurance
16 impounds. The Arizona Supreme Court denied the claim because the contract required the
17 borrower to pay the impounds and did not require the lender to repay interest on those amounts.
18 The court denied the unjust enrichment claim based on Restatement of Restitution § 107,
19 Comment (1)(a), which provides that unjust enrichment does not lie where one receives from
20 the other that which it was agreed he should receive. The court's reference to the existence of a
21 contract barring an action for unjust enrichment obviously does not apply where one party paid
22 more than the contract required.

23 Here, there is apparently no contract that required the Debtor to pay Kohlberg
24 the excess \$2.9 million in 1996, nor is there any contract that expressly required Kohlberg to

25 ³⁴ *Ashton Company Inc. v. State of Arizona*, 9 Ariz. App. 564, 454 P.2d 1004 (1969).

26 ³⁵ 454 P.2d at 1010.

27 ³⁶ *Brooks v. Valley National Bank*, 113 Ariz. 169, 548 P.2d 1166 (1976).

1 repay such amount. In the absence of such contractual rights, a claim for unjust enrichment
2 may be allowed where the Plaintiff can show: (1) an enrichment; (2) an impoverishment; (3) a
3 connection between the enrichment and the impoverishment; (4) absence of justification for the
4 enrichment and the impoverishment; and (5) an absence of a remedy provided by law.³⁷

5 Kohlberg has failed to establish that any of those elements is lacking here. To the contrary, it
6 affirmatively appears that Kohlberg was enriched by \$2.9 million, that the Debtor was
7 impoverished to that extent, that there is a precise correlation between those amounts, that
8 Kohlberg has no justification for its enrichment or the Debtor's impoverishment, and that there
9 is no other remedy provided by law. Consequently Kohlberg's motion to dismiss the unjust
10 enrichment Count 2 must be denied.

11 While there ultimately cannot be liability both for unjust enrichment and breach
12 of contract, a plaintiff is entitled to plead in the alternative.³⁸ The Trustee has pled facts from
13 which a jury could conclude that both the Debtor and Kohlberg regarded the \$2.9 million as a
14 receivable due the Debtor from Kohlberg, right up until the filing of bankruptcy. This implies
15 the parties recognized the existence of a contractual obligation to pay that amount, even though
16 no such term can be found in any of the written contracts. Consequently Kohlberg's motion to
17 dismiss Count 3 must also be denied.

18 **Deepening Insolvency May Provide A Measure of Damages**

19 Kohlberg has moved to dismiss the "deepening insolvency" claim asserted by
20 Count 7 of the Second Amended Complaint on several grounds: (1) statute of limitations; (2)
21 failure to state a claim because deepening insolvency is not a recognized cause of action; and
22 (3) failure to state a claim because the complaint fails to allege that the increased debt was
23 incurred fraudulently.

24 The Trustee responds, however, that "the Complaint uses deepening insolvency
25

26 ³⁷ *Community Guardian Bank v. Hamlin*, 182 Ariz. 627, 630 (Ariz. App. 1995).

27 ³⁸ Bankruptcy Rule 7008, incorporating F.R.Civ.P. Rule 8(e).
28

1 as a measure of damages, not as a cause of action.”³⁹ The Trustee argues that deepening
2 insolvency is pled as a damages theory for causes of action based on breach of fiduciary duty
3 (Count 7), gross negligence and mismanagement (Count 10), and assisting in the breach of
4 fiduciary duty (Count 13).

5 The Trustee’s characterization of the Second Amended Complaint is correct. A
6 motion to dismiss is not an appropriate procedure to test the Trustee’s deepening insolvency
7 theory of damages. The complaint adequately specifies other damages, such as the acquisition
8 and management fees, tax overpayment and Pack buyout, that are sufficient to state a claim for
9 breach of fiduciary duty. The Court therefore need not now determine whether the Trustee may
10 also be able to prove whether additional damages also flowed from the Defendants’ breaches of
11 fiduciary duty.

12 Kohlberg’s motion to dismiss Count 7 for failure to state a claim for relief for
13 deepening insolvency must therefore be denied, because Kohlberg’s motion does not establish
14 that it fails to state a claim for breach of fiduciary duty. Kohlberg’s motion to dismiss Count 7
15 as being time barred must also be denied, because the Court has already concluded that the
16 statute of limitations does not bar the Trustee’s claim for breach of fiduciary duty.

17 **Payment of Debts Fraudulently Incurred May Be Actual Fraudulent Transfers**

18 Count 12 of the Second Amended Complaint alleges that all of the transfers of
19 Southwest Supermarkets’ funds to the Defendants were made for less than fair consideration
20 and rendered Southwest Supermarkets insolvent. The Count also alleges that these transfers
21 were done intentionally with an “evil mind,” for the Defendants’ own benefit, and with reason
22 to know or conscious disregard of the substantial risk that the transfers would damage
23 Southwest Supermarkets and its creditors.

24 In *Collins I*, this Court held that constructive fraudulent transfer claims for
25 payments made prior to November 1997 are barred by the statute of limitations.⁴⁰ Kohlberg

26
27 ³⁹ Plaintiff’s Supplemental Brief at 19.

28 ⁴⁰ 315 B.R. at 576.

1 now moves to dismiss Count 12 as failing to state a claim for an actual fraudulent transfer
2 pursuant to A.R.S. § 44-1004(A)(1). Kohlberg argues that the acquisition and management fees
3 cannot be actual fraudulent transfers because they were paid pursuant to a contract. Kohlberg
4 also argues that the tax overpayment cannot be an actual fraudulent transfer because it arose
5 from the innocent miscalculation of the amount required to be paid pursuant to a contract to
6 cover Kohlberg's tax liabilities arising from its ownership of Southwest Supermarkets.

7 Count 12 is not very artfully drafted if it is interpreted as asserting a claim for
8 actual fraudulent transfer. Beyond the conclusory allegation that the transfers were done with
9 "an evil mind," Count 12 only references two facts: that the transfers were for less than fair
10 consideration and that they rendered Southwest Supermarkets insolvent. These facts are more
11 suggestive of a constructive fraudulent transfer than an actual fraudulent transfer.

12 Such facts are, however, also "badges of fraud" that may give rise to an
13 inference of actual intent to hinder, delay or defraud creditors.⁴¹ When coupled with the
14 pleading of "an evil mind," such allegations are therefore sufficient to state a claim for actual
15 fraudulent transfer under the rules of notice pleading.

16 Kohlberg's argument that the transfers were made pursuant to a preexisting
17 contract is often sufficient to defeat a claim for fraudulent transfer. This is because
18 performance of a contract is, in essence, satisfaction of a debt, and satisfaction of a debt
19 generally provides reasonably equivalent value for the amount transferred. Consequently
20 although performance of a contract or payment of a debt may be avoidable as a preference, it is
21 usually not avoidable as a fraudulent transfer. One leading scholar of fraudulent transfer law
22 repeatedly stated in his treatise that a preference, as such, can never be a fraudulent transfer.⁴²

23 There is a substantial caveat to that broad proposition, however, and that is

24 ⁴¹ A.R.S. § 44-1004(b)(8) & (9).

25 ⁴² "[W]e are now to ask whether a preference, as such, is a fraudulent conveyance. The answer
26 is certainly, No; and of that the reader may rest assured. If there is in our law one point which is more
27 ungrudgingly accepted than others, it is that the preferential transfer does not constitute a fraudulent
28 conveyance. The 'past consideration' is the 'good consideration' that the Statute of Elizabeth
requires." I GARRARD GLENN, FRAUDULENT CONVEYANCES AND PREFERENCES § 289, at 488 (Rev.
Ed. 1940). See also II GLENN, § 382, at 661.

1 where there are other badges of fraud present, such as an insider relationship between the debtor
2 and the payee.⁴³ In fact, this caveat is perhaps best illustrated by the case that gave rise to the
3 badges of fraud, *Twyne's Case*. It is often overlooked that Coke's report actually states that the
4 debtor Pierce "was indebted to Twyne in four hundred pounds," and "being possessed of goods
5 and chattels of the value of three hundred pounds, in secret made a general deed of gift of all his
6 goods and chattels, real and personal whatsoever to Twyne, in satisfaction of his debt."⁴⁴ While
7 payment of such debts alone should not have constituted a fraudulent transfer, Coke concluded
8 that the transfer was fraudulent because of the presence of badges of fraud such as the fact that
9 the debtor retained possession of the sheep and they remained branded with the debtor's brand.
10 Similarly, payment of a debt incurred as part of a fraudulent Ponzi scheme may be a fraudulent
11 transfer.⁴⁵

12 Here, as noted above, there are two badges of fraud specifically referenced in
13 Count 12 itself. Moreover, the transfers were to insiders, which is another badge of fraud.⁴⁶
14 More importantly, the contracts that gave rise to the obligations to pay the acquisition fee,
15 management fee and tax advances may themselves have been obligations incurred with an
16 actual fraudulent intent to hinder, delay or defraud creditors. They are alleged to be part of a
17 broad scheme to milk the debtor. Indeed, they bear the same badges of fraud, including being a
18 transaction with an insider, for which the Debtor may not have received reasonably equivalent
19 value while insolvent. Obviously if the underlying contracts are avoidable as fraudulent
20 transfers, then the Debtor did not receive reasonably equivalent value by satisfying an
21 obligation that is void or voidable.

22
23 ⁴³ *Id.* § 289(a), at 493.

24 ⁴⁴ *Twyne's Case*, 3 Coke 806, 76 Eng. Rep. 809 (Star Chamber, 1601), reprinted in ELIZABETH
25 WARREN AND JAY LAWRENCE WESTBROOK, *THE LAW OF DEBTORS AND CREDITORS*, at 127-28 (4th Ed.
2001).

26 ⁴⁵ *E.g.*, *Hayes v. Palm Seedlings Partners (In re Agricultural Research and Technology*
27 *Group)*, 916 F.3d 528 (9th Cir. 1990); *In re Bonham*, 251 B.R. 113 (Bankr. D. Alaska 2000).

28 ⁴⁶ A.R.S. § 44-1004(B0(1)).

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Kohlberg’s motion to dismiss Count 12 must therefore be denied.

Dissolved Partnerships

Finally, Kohlberg moves for dismissal from the complaint of three Delaware Limited Partnerships that were dissolved and filed certificates of cancellation on May 16, 2003.⁴⁷ Kohlberg argues that after the filing of the certificate of cancellation, these limited partnerships ceased to exist and therefore cannot be sued.

If Kohlberg is correct, the point is both moot and Kohlberg lacks standing to argue it. If there is no entity there, then the Trustee’s suit will gain him nothing but similarly cause harm to no one. But if there is no such entity, then who hired Perkins Coie Brown & Bain and Paul, Weiss, Rifkind to seek its dismissal? If the limited partnerships did so, they must exist and have assets sufficient to pay their lawyers. But if they did not do so on their own behalf, then who did? It is difficult to see how the other Kohlberg defendants would have standing to move for their dismissal.

Kohlberg’s motion to dismiss the dissolved limited partnerships is therefore denied.

Dated this 26th day of May, 2005.

/s/ Randolph J. Haines
U.S. Bankruptcy Judge

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⁴⁷ The three defendants are KSSI Acquisition Company, L.P.; KSSI Acquisition Company II L.P.; and KSSI Management L.P.

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